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CONSULTING GROUP
NEW YORK · LONDON

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President

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Dear Sir or Madam:

As I write my annual letter, I can't help but to think about celebrity chef Emeril Lagasse's exclamation "BAM!" This has been a year in which the card industry has "taken it up a notch."

In May, MasterCard went public, and shortly thereafter, Visa announced a two-phase restructuring plan that will end with an IPO. If you didn't buy a ton of MasterCard stock, you should be disappointed (I admit, I am!). The fact that the stock has gone from $40 to more than $90 a share is both surprising and exciting, especially considering that it did so in the face of an uncertain economy as well as litigation risk and regulatory pressure. You have to wonder what will happen in the future. And when Visa goes public, it will be interesting to see how it is priced and how the markets react. We are also curious to see the interaction Visa Europe will have with the new public entity.

Discover has made some headway in the past few months as well. Its new ad campaign positions Discover as the card for clear control of finances. Meanwhile, on the merchant side of its business, Discover has expanded acceptance globally and domestically by partnering with JCB, China Unionpay and Central America's Credomatic, and by purchasing the Pulse ATM Network. These alliances allow Discover to significantly increase its acceptance, which has been one of its greatest challenges.

Bank of America completed its purchase of MBNA in January. Capital One closed the Hibernia transaction and announced the North Fork Bancorp deal, putting its identity as the last significant monoline deep into mothballs. These moves reflect the broader trend of reuniting retail banking and credit cards that we identified in our 2005 letter. To be successful, institutions will have to focus on integrating technology platforms, leveraging data across business lines and putting corporate objectives ahead of line-of-business objectives. The silo mentality has to become as old-fashioned as the monoline itself. If early results are any indication, this marriage of retail banking and credit cards will continue to mature in 2007 and beyond.

Another topic on US issuers' minds is the effect of the 2005 bankruptcy reform on their profitability. While the legislation was meant to make consumer debt elimination more difficult, common wisdom suggests that bad debt levels are unlikely to decline significantly. 2006, however, will be a good year for losses as large write-offs were experienced in 2005. Lenders may not be hurt any more than they were before the legal change, but the reform likely will not have the long-term effect the industry desired. Although the number of people submitting to credit counseling is dropping, ACG finds that 95 to 97 percent of those consumers still file for bankruptcy. Others, that might have gone bankrupt, are now simply charging off after running the course of delinquency. Indeed, our clients are expressing concern that bankruptcy filings may rise as variable-rate mortgage payments and credit card minimum payments increase, and high oil prices and housing cost increases squeeze consumers. Combined with the gentle leak of air from the housing bubble, consumers may resort to charging more of their basics to credit cards and perhaps paying less of their balances, ultimately risking greater credit card losses.

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Partnerships continue to add vibrancy to the card business, and co-branding still constitutes a staple of ACG's business. Most 2006 co-brand activity at ACG centered on retailer partnerships and existing program renegotiation. Surprisingly, this year we saw as many deals in which overcompensated partners agreed to reduced revenues as those in which the issuers were incented to increase their offerings to the brand partner. We also welcome the new partnership "flavors" that appeared this year. American Express's Starwood Hotels and JetBlue Airways corporate card introductions are two good examples. US Bank's innovative alliances with PNC and Lexus are also of interest. These "value-added alliances" as we call them, are like super-charged co-brand deals. The bank provides credit card expertise and management, and the partners take an active role in portfolio ownership and profitability. Managed properly, these should prove very healthy and robust partnerships.

I am happy to report that innovation is waxing again in the card industry after a long dearth of originality. RFID and near-field communications (NFC) technology, new acquisition channels, retail banking relationship programs, debit and corporate card reward programs are among the areas we see being explored. More interesting, though, our clients are asking with greater frequency how they can open themselves to innovation. Of course, we have the answers! We have advocated embracing creativity for some time. Perhaps now we will have a chance to prove our mettle in this emerging area.

One of the biggest challenges of innovation seems to be the size (or lack thereof) of new concepts. Today's leading players are mammoth organizations with robust machines that need to be fed in big bites to be sustainable. Certainly finding new concepts that are significant enough to "move the needle" is becoming more and more difficult. These issuers have clearly demonstrated their ability to integrate large opportunities. We believe that to continue to grow, they will also need to foster a number of attractive but smaller concepts, allowing them to take root and flourish.

Of course, there is no shortage of exciting news at ACG this year either.

In June, we opened our first international office. Located in the Mayfair district of London's West End, Michael Lenora serves as the Managing Director of ACG abroad. He's a veteran of Associates First Capital Corp., Goldman Sachs Ventures and Barclaycard International, and now takes the reins of ACG client activity in the United Kingdom and Continental Europe as well as Africa and the Middle East.

Some of our recent UK efforts focus on stimulating Britons' credit card use. At the beginning of 2006, British issuers suffered a blizzard of chargeoffs and delinquencies, thus credit lending was put on ice. By the end of September, repayments were exceeding spending, and net lending had actually contracted compared to 2005 figures. It is more important now than ever before for issuers to be able to do more with less and to be firing on all cylinders. Maybe that is why the market leaders are telling us we could not have picked a better time to set up shop in one of the world's most exciting card markets.

Another struggle for European issuers is the creation of uniform credit card transaction processes among EU countries. European Union states are preparing to make consumer spending with the common currency easier through Single Euro Payments Area (SEPA) standardization. As the impact of SEPA on European credit and debit card issuers cannot be overstated, ACG is working to help leading institutions understand the directive, set priorities and affect the transition.

On both sides of the Atlantic, our Industry Roundtables continue to caucus the opinions and input of decision makers. Currently, 15 working groups identify emerging trends and challenges related to credit and debit card operations as well as the auto finance market and the unsecured (non-credit card) loan arena. A variety of new groups are planned for 2007, including a Branch Banking Roundtable for our growing retail banking client base.

In addition to the direct benefits our clients enjoy from participation in our forums, the groups have spawned new opportunities to aid our industry. Several concepts conceived at the forums are currently in development. These include consumer education about bankruptcy ramifications and alternatives, a unified approach to data breaches and a common certification process for recovery agencies. We are excited to pursue these and other projects as the new year unfolds.

We have also continued to increase our focus on supplying the industry with top notch, actionable benchmarking data. Often these studies result from Roundtable meetings. However, many others are conducted as independent projects designed to gather time-sensitive data and set organizational direction. As of the end of October, we had completed 150 benchmark studies this year alone. Our mission is to become known as *the* source for quality information.

This year, Cardbeat®, our US-based monthly market research tracking study continued to gauge cardholder behavior and perspectives, and build long-term trend data for ACG's clients. We recently announced that beginning in 2007, Cardbeat will be published quarterly in the United Kingdom as well. Similar to the US edition, the publication will compile consumers' brand perceptions and credit card usage patterns. The first report will ask British consumers the same questions the US version asks of American consumers. (Subsequently, the two platforms will run independently.) Subscribers will receive both countries' editions of the first issue so that they can compare and contrast British and American public opinions. We anxiously await the results.

Change of this magnitude precipitated a fresh brand identity for our firm. Some of you are seeing the new look for ACG, including the redesigned logo, for the first time with this letter. We certainly hope you will become familiar with it in 2007 on proposals, presentations, insight pieces and Industry Roundtable materials.

As you can see, both the industry and ACG "took it up a notch" in 2006. Given the pace of change, I almost hesitate to put this letter in the mail. What will I miss marking in this time capsule? Thank you for lifting ACG to the next level in 2006. We look forward to helping propel you toward your goals, whether big or small, in 2007.

Best regards,

Michael Auriemma